DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0170
Gross Income Tax
For the Years 1994 through 1998

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ISSUES

I. **Service-Related Income Received from the Sale and Installation of Industrial Equipment** – Gross Income Tax.

Authority: U.S. Const. art. I, § 8; IC 6-2.1-3-3; IC 6-8.1-5-1(b); Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982); Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953); 45 IAC 1-1-100; 45 IAC 1-1-120; 45 IAC 1-1-120(1)(c); 45 IAC 1-1-120(d); 45 IAC 1-1-121(d).

Taxpayer argues that the audit erroneously subjected service-related income to Gross Income Tax.

II. **Audit's Assessment Calculation** – Gross Income Tax.

Authority: IC 6-8.1-5-1(a); IC 6-8.1-5-1(b).

Taxpayer challenges the audit's method of calculating its tax liability arguing that the audit's methodology was inconsistent and unfair.

III. **Abatement of the Ten-Percent Negligence Penalty**.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it exercised the required business care and prudence in filing its tax returns. As a result, taxpayer argues that it is entitled to abatement of the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer was an out-of-state entity engaged in the business of designing, manufacturing, and installing industrial air pollution equipment. That equipment included cooling towers, electrostatic precipitators, and industrial chimneys. Over a period of time, taxpayer was

acquired by parent company and became a wholly-owned subsidiary of that parent company. In 1997, parent company decided to discontinue taxpayer's business. A second parent company subsidiary was assigned to oversee the taxpayer's final affairs.

It was in that context that the Department conducted an audit of taxpayer's business records for 1994 through 1998. The Department's audit was completed in 2001 and resulted in an assessment of additional tax liability for those years. Taxpayer submitted a protest, an administrative hearing was held, and this Letter of Findings results.

DISCUSSION

I. Service-Related Income Received from the Sale and Installation of Industrial Equipment – Gross Income Tax.

Taxpayer was paid to design, construct, and install certain types of industrial equipment. The equipment was installed at locations nationwide including locations within the state. The size and complexity of that equipment varied. For example, taxpayer constructed precipitators ranging from the size of a five-story building to the size of a large van. Taxpayer built 500 foot high natural draft cooling towers and also built much smaller mechanical cooling units. Taxpayer was paid for the materials used in construction of the equipment and for services related to the design, construction, installation, and testing of the equipment.

In addition, the audit determined that taxpayer received service-related income. According to the audit, the taxpayer received money for engineering, asbestos removal, water management, and other services.

However, taxpayer raises the issue of whether service related income attributable to its construction and installation activities is subject to the state's Gross Income Tax. In particular, taxpayer argues that the Interstate Commerce Clause, U.S. Const. art. I, § 8, precludes Indiana from taxing this income. The crux of taxpayer's argument is that the service-related income stemmed from the construction of equipment outside of Indiana and that the services rendered in conjunction with the construction of the equipment were integrally related to the out-of-state transaction. Any services taxpayer performed inside Indiana were so integrally related to the underlying interstate sales transaction, that the service income came within the protection provided by the Commerce Clause.

Taxpayer is correct in its assertion that Indiana is precluded from assessing the un-apportioned Gross Income Tax on income derived from out-of-state transactions. The constitutional protection is incorporated into IC 6-2.1-3-3 which states as follows:

> Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

Taxpayer cites to Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982) in support of the proposition that Indiana sales of its equipment were not subject to the Gross Income Tax. In Brown Boveri, plaintiff taxpayer was an out-of-state company which had entered into a contract with an Indiana manufacturer for the sale of an induction melting system. The parties' sales agreement was for the "turn-key" delivery of a system that would produce molten iron. "The system was pre-fabricated at [plaintiff taxpayer's] plant, broken down for shipment and reassembled at the [Indiana customer's] plant." Id. at 563. Plaintiff taxpayer conducted certain activities at the Indiana site because it "was necessary for [plaintiff taxpayer] to engage in various activities to guarantee proper planning and coordination of the project." Id.

The court disagreed with the Department's argument that plaintiff taxpayer's performance of activities within Indiana removed the transaction from the protection afforded interstate commerce. Id. at 564. The court found that the transaction between plaintiff taxpayer and the Indiana customer was "indeed interstate commerce such that taxation of gross income resulting therefrom [was] prohibited." Id. The transaction was for the "sale of a functioning system for a lump sum," in which "all of the component parts were pre-fabricated outside Indiana, disassembled for shipment, and then reassembled on the job site." Id. Plaintiff taxpayer's local activities did not take the sale of the melting system outside interstate commerce protection because "the local activities of [plaintiff taxpayer] were intrinsically related to and inherently part of the sale in interstate commerce." Id.

In addition, taxpayer cites to Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953) for support of its contention that the sale of the industrial equipment to its Indiana customers took place within interstate commerce and the service-related proceeds were exempt from Gross Income Tax. In Surface Combustion, appellee taxpayer was an Ohio based furnace manufacturer. It sold furnaces to an Indiana customer, was assessed Gross Income Tax on the income derived from the sales, and brought an action seeking a refund of those taxes. The court determined that appellee taxpayer had constructed the furnaces at its Ohio facility. Thereafter, appellee taxpayer transported the smaller furnaces to the Indiana customer's site. The larger furnaces were assembled at the Ohio facility, disassembled, and shipped to the Indiana site; alternatively, the larger furnaces were only partially assembled at the Ohio facility before being "knocked down," transported and reassembled at the Indiana customer's site. In each case, the court found that the "parties contemplated and intended that the furnace . . . should be shipped and transported from appellee's plant at Toledo, Ohio to the customer's plant in Indiana . . . ." Id. 53.

The court rejected the Department's contention that it was entitled to levy the Gross Income Tax against appellee taxpayer's income derived from the sale of the furnaces. The court found that, "the tax sought to be recovered was levied upon the gross receipts of appellee from interstate commerce transactions within and without the State of Indiana." Id. at 69. The court concluded that imposition of the tax "directly burdens, and interferes with, the free flow of such commerce between the State of Ohio and the State

of Indiana and is invalid as being in conflict with Article I, of § 8 of the Constitution of the United States." Id.

The court found that the "thing" which the Indiana customer purchased from appellee in Ohio, was a "heat treating furnace complete in one functional unit." Id. at 62. In support of that conclusion, the court noted that, "There is no evidence that the furnaces were made, built, fabricated, created or brought into existence in Indiana." Id. The Indiana installation work performed by appellee taxpayer consisted "only in the reassembling and installing the furnaces which had been purchased in the State of Ohio and taken apart for the convenience of shipment." Id. Appellee taxpayer's in-state services were "intrinsically related to and inherently a part of the sale; and because of their complexity their installation and testing was essential to the making of the sale." Id. The sales of the furnaces were "clearly sales of personal chattels in interstate commerce and the installation and reassembling where required, were inherently a part of, and a necessary incident to, the sale." Id.

Taxpayer maintains that the Department should follow the Indiana Supreme Court's precedent in Brown Boveri and Surface Combustion and conclude that its service income was so intrinsically related to the transfer of the industrial equipment from outside Indiana as to constitute a continuous interstate transaction entirely removed from the state's Gross Income Tax pursuant to IC 6-2.1-3-3.

Taxpayer is correct in its assertion that income derived from provision of in-state services may be beyond the reach of the Gross Income Tax. In regard to "Nontaxable in-shipments," the regulation states that, "As a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the state and such activity was connected with or facilitated the sales." 45 IAC 1-1-120. Specifically, the regulation exempts those sales "made by a nonresident where the product sold is, because of its size or weight, shipped in parts; and the seller, because of his special skill or expertise, assembles or installs the product at the buyer's place of business with no additional services rendered." 45 IAC 1-1-120(1)(c). Accordingly, when a vendor builds a piece of equipment out-of-state, ships the equipment into the state – either as a single unit or disassembled for ease of transport – and thereafter performs certain limited on-site services to install the equipment at the Indiana location, the state may not subject the transaction's service related proceeds to the unapportioned Gross Income Tax.

However, the regulation also recognizes that "Gross receipts from contracts entered into by nonresidents to furnish and install tangible personal property in Indiana are subject to gross income tax." 45 IAC 1-1-121(d).

Taxpayer argues that its income is derived from exempt in-shipments. The audit determined that the income was derived from essentially in-state transactions. 45 IAC 1-1-121(d) sets out the rule:

> The problem . . . is deciding if the contract is simply one of sale with incidental services taking place within the State, which may be tax exempt as a transaction in interstate commerce, or one of service which is taxable if it takes place in Indiana. The Department interprets the relevant court decisions to mean that whenever a product is shipped in parts as a convenience to transportation and the seller then assembles it or supervises assembly on the customer's premises, the transaction is a sale if the following conditions are met:
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> > installation consists of no more than setting the product on bases or connecting it to pipes, wires, supports, etc., provided by the customer;
> >
> > the product remains personal property after installation;
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> > the property is suitable for sale to other customers in the regular course of the seller's business;
> >
> > and the service necessary to installation is of such a technical nature that only the seller is capable of providing the necessary skilled workmen.
>
> If these conditions are not met or if, in addition to assembly, the seller performs additional services, such as installation, testing, construction, etc., the transaction will not be considered a sale but will be treated as a construction project.

Therefore, if a hypothetical out-of-state vendor of air conditioning equipment contracted to provide a compressor to an Indiana customer, shipped the compressor into the state, and had its trained technicians connect the device to the Indiana customer's pipes and wires, the transaction would be a "sale" and the proceeds would not be subject to the Gross Income Tax. With perhaps the minor exception of certain loose parts, the compressor was shipped as a single unit, the compressor remained "personal property" after it was installed, and the compressor could have been sold to a different customer if the Indiana customer reneged on the deal. In addition, the out-of-state vendor performed no elaborate "installation, testing, construction" services within Indiana.

Taxpayer argues that it is in the same position as the hypothetical air conditioning vendor. In particular, taxpayer argues that its transfers of "lower-gas-flow precipitators and mechanical draft cooling towers" fall within the definition of "sales" set out in 45 IAC 1-1-121(d). Taxpayer cites to several Revenue Rulings which found variously that the provision of a "piece of equipment" the "sale and installation of pollution control equipment" were not subject to the state's Gross Income Tax. However, the cited Revenue Rulings are of little assistance because the Rulings are brief, conclusory statements that do not provide the guidance or analysis necessary to resolve the particular issue raised by taxpayer.

It is apparent that taxpayer's installation of large scale cooling towers, electrostatic precipitators, and various items of pollution control equipment qualifies it as a "contractor" under 45 IAC 1-1-100 and that its own activities are not analogous to the

limited in-state service activities described in Brown Boveri and Surface Combustion. The installation of the large scale precipitators, cooling towers, and other pollution control equipment, were lengthy, complex projects in which the devices were first brought into being at the Indiana location. Unlike the out-of-state manufacturers in Brown Boveri and Surface Combustion, taxpayer did not simply construct this equipment outside the state, disassemble the devices for ease of transport, and then reassemble the equipment at the Indiana location. The sheer scale of taxpayer's projects – some of which took years to complete – belie the contention that this equipment was constructed outside Indiana, disassembled, transported, and then simply reassembled at the Indiana location. In addition, it would seem apparent – given the complexity, scale, and specialization of these devices – that the taxpayer "perform[ed] additional services, such as installation, testing, construction" (45 IAC 1-1-121(d)) once the component parts were brought to the Indiana site.

It is possible that taxpayer entered into transactions for the provision and installation of certain equipment and that those transactions fell within the definition of a "sale" as set out in 45 IAC 1-1-121(d). A contract for taxpayer to supply an Indiana customer with a precipitator "the size of a large van" conceivably could have been a transaction similar to that of the hypothetical air conditioning manufacturer noted above. However, there are simply no conceivable circumstances under which the delivery of "500 foot high natural draft cooling towers" would have constituted the kind of "sale" envisioned under 45 IAC 1-1-121(d). Taxpayer has done nothing to identify a specific, potentially exempt "sale" and then to "tie" that particular transaction to the findings contained within the audit report. Taxpayer has provided no support for the proposition that the audit assessment should be rejected in toto because of the possibility that certain undefined 1994 through 1998 Indiana transactions may have fallen within the definition of an exempt "sale." Because taxpayer has not met its "burden of proving that the proposed assessment is wrong," (IC 6-8.1-5-1(b)), the Department is unable to grant the requested relief.

FINDING

Taxpayer's protest is respectfully denied.

II. Audit's Assessment Calculation – Gross Income Tax.

Taxpayer argues that the audit's assessment of additional Gross Income Tax was fundamentally flawed because the audit "utilized an inconsistent methodology in ascertaining [taxpayer's] liability." According to taxpayer, the audit determined the amount of liability by reviewing sales and use tax reports and then comparing those reports to information listed on the taxpayer's tax returns. Thereafter – again, according to taxpayer – when information contained on the returns revealed a greater number than indicated on the sales and use tax reports, the audit adopted the number indicated on the returns. Conversely, when the information contained on the sales and use tax reports indicated a greater amount than that reported on the returns, the audit adopted the number indicated on the sales and use tax reports. In effect, the audit purportedly utilized whichever number resulted in the greater tax assessment. In addition, taxpayer argues that

the audit's reliance on the sales and use tax reports is – in itself – problematic. Taxpayer explains that, "Sales tax is collected by the seller and then paid to the State of Indiana on a cash basis [while] Gross receipts are reported on an accrual basis when the sale is made."

The taxpayer offers no alternative assessment of its tax liability. Instead, the taxpayer asks the Department to reject the audit results because the results are "patently unfair to the taxpayer."

At the time of the audit, taxpayer's representatives – acting on behalf of the expired entity – were unable to provide the audit with complete financial records for the years at issue. From the information provided, it is evident that the audit had access to a limited number of sales and use tax records and that not all federal and state returns "were available or could be located." Accordingly, the audit indicated that the report was completed based upon "the best information available."

As noted in the audit report, the Department is entitled to make an assessment of taxes based upon "the best information available." IC 6-8.1-5-1(a) states that, "If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department." In addition, the statute places the burden of refuting such a proposed assessment on the taxpayer. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b).

Taxpayer argues that the audit report "mix and match[ed]" the available information to produce the results that best suited the Department. However, taxpayer's bare assertion – that it is aggrieved by the audit methodology – is insufficient to establish that "the proposed assessment is wrong . . . ." Taxpayer's representatives may be in the awkward position of having to establish the precise obligations of an entity which has undergone successive changes of ownership; however, taxpayer's representatives have offered no substantive, verifiable, superior, or reliable substitute for the audit's own conclusions.

The audit – faced with the responsibility of arriving at a determination of tax liabilities for a period spanning five years and six tax-reporting periods – arrived at a conclusion in spite of the fact that the audit had access to few existing records and in spite of the fact that taxpayer's own personnel, at the time of the audit, had very little understanding of taxpayer's past business or financial activities. There is simply no evidence that the audit's additional assessments were capricious, whimsical, or arbitrary. The Department must conclude that there is plainly no justification for setting aside the audit's conclusions because taxpayer has been unable to demonstrate that the assessments are quantifiably wrong, and because taxpayer has not been able to offer an alternative assessment which is demonstrably more reliable.

FINDING

Taxpayer's protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

The audit concluded with the recommendation that a ten-percent negligence penalty be assessed. Taxpayer argues that the Department should exercise its discretion to abate the penalty because it "acted reasonably and with the requisite business care and prudence in filing its tax returns."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department is unable to agree with taxpayer's argument that its original returns represented a reasonable interpretation of the law and that, in preparing those original returns, it "exercised ordinary business care." Taxpayer raised the substantially identical issues with the Department following an earlier audit report. Although the taxpayer may have disagreed with the results of the earlier Letter of Findings which addressed those issues, taxpayer is not now entitled to assert that the issues were not addressed within the Letter of Findings or that it is unaware of the conclusions contained in that Letter of Findings. In addition, taxpayer is not now entitled to assert that the Letter of Finding's conclusions – sustaining taxpayer's protest in part and denying the protest in part – did not provide taxpayer with the specific guidance necessary for it to prepare its Indiana tax returns in a manner and to a degree which comported with the Indiana's Gross Income Tax law.

Further, the Department finds that the absence of adequate financial records can be interpreted as the lack of the "requisite business care and prudence" which would otherwise permit the Department to abate the penalty. Taxpayer's representative may be handicapped by the fact that taxpayer is not now a functioning business entity. Nonetheless, taxpayer was not a marginal "mom-and-pop" operation which unexpectedly vanished from the face of the earth. Taxpayer's substantial operations were absorbed by the parent company and a related entity was charged with the specific responsibility of winding down taxpayer's remaining business obligations including its outstanding tax liabilities. In its time, taxpayer was a substantial and sophisticated business operation having income, obligations, and contracts measured in the many-millions of dollars. The fact that the audit report had to be pieced

together based upon vague, incomplete, and missing information is not evidence of the sort of "ordinary business care and prudence" expected of an "ordinary reasonable taxpayer" that would warrant abatement of the ten-percent negligence penalty.

FINDING

Taxpayer's protest is respectfully denied.

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